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Securities Regulation - Securities Exchange Act - Cooperative

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SECURITIES REGULATION—SECURITIES EXCHANGE ACT—COOPERATIVE—Uncollateralized, unsecured demand notes sold as an investment vehicle fall within both the "note" and "security" categories of section 3(a)(10)of the Securities Exchange Act.

Reves v Ernst & Young,____US____, 110 S Ct 945, 948 (1990).

The Farmers Cooperative of Arkansas and Oklahoma, Inc. (hereinafter, "Co-op") obtained a portion of its general business operating funds from the sale of uncollateralized, uninsured demand promissory notes.[1] The notes were sold on an ongoing basis to both Co-op members and nonmembers.[2] Marketed as an investment device, the notes paid a variable rate of interest higher than that which was paid by local financial institutions.[3] No financial information regarding the Co-op was released to the purchasers except a statement of the Co-op's total assets, which was released periodically.[4]

Arthur Young[5] was engaged by the Co-op to audit and report on the Co-op's 1981 and 1982 financial statements.[6] The audited financial statements were not publicly released.[7] The management of the Co-op drafted condensed financial statements which were distributed at the Co-op's annual shareholder meeting.[8] Representatives of Arthur Young spoke to the Co-op members at both the 1981 and 1982 annual meetings and described the general financial status of the Co-op.[9] The members were informed that copies of the full audited financial statements and the reports which were prepared by Arthur Young were available at the Co-op's office.[10]

The Co-op became insolvent and subsequently filed for bank-

1. *Reves v Ernst & Young*,____US____, 110 S Ct 945 (1990). A demand promissory note is a written promise committing the issuer to pay the specified sum of money on demand, with or without interest. Demand notes are negotiable. *Dictionary of Finance And Investment Terms* 311 (Barron's, 2d ed 1987).
2. *Reves v Ernst & Young*, 856 F2d 52, 53 (2d Cir 1988).
3. *Reves*, 110 S Ct at 948.
4. *Reves*, 856 F2d at 53.
5. Arthur Young was the predecessor to Ernst & Young.
6. *Reves*, 856 F2d at 53.
7. Id.
8. Id.
9. Id.
10. Id.

ruptcy in 1984.[11] Holders of the demand notes (hereinafter, "Class") brought suit against Arthur Young, alleging violation of the anti-fraud provisions of the Securities Exchange Act of 1934.[12] The noteholders alleged that Arthur Young had failed to follow generally accepted accounting procedures which would have revealed the Co-op's insolvency to prospective note purchasers.[13] The district court entered judgment on a jury verdict, holding that Arthur Young had violated section 10(b) of the Securities Exchange Act and section 67-1256 of the Arkansas Securities Act in connection with the sale of the demand notes.[14] Arthur Young appealed the district court's decision.[15]

The Class cross-appealed, claiming that the district court erred in crediting settlement proceeds against the jury verdict and in granting summary judgment in favor of Arthur Young on the Class' claim under the Racketeer Influenced and Corrupt Organizations Act ("RICO").[16]

The United States Court of Appeals for the Eighth Circuit reversed the denial of Arthur Young's motion for judgment n.o.v. and entered judgment for Arthur Young. The Class' and Trustee's claims were dismissed.[17]

The United States Court of Appeals for the Eighth Circuit examined the status of the notes according to a test developed by the

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11. *Reves*, 110 S Ct at 948.

12. Id. The Securities Exchange Act is codified as amended in 15 USC §§ 78a-78jj (1982 & Supp 1987). The Securities Exchange Act regulates specified investment instruments including "any note[s]." 15 USC § 78c(a)(10) (1987).

13. *Reves*, 110 S Ct at 948.

14. *Reves*, 856 F2d at 53. Section 10(b) of the Securities Exchange Act provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
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> (b) To use or employ, in connection with the purchase or sale, of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may proscribe as necessary or appropriate in the public interest or for the protection of investors.

15 USC § 10(b), 48 Stat 891, codified as amended in 15 USC section 78j(b). The Arkansas Securities Act was not discussed by the Supreme Court. *Reves*, 110 S Ct at 954.

15. Id. Arthur Young appealed on five grounds: 1) the denial of Arthur Young's motion for new trial or judgment n.o.v.; 2) the award of costs to the Trustee and Class; 3) the award of attorney's fees to class counsel; 4) the calculation of pretrial and post-trial post judgment interest; and, 5) the denial of its petition for costs against the Trustee and Class. *Reves*, 856 F2d at 53.

16. Id. The provisions of RICO can be found at 18 USC §§ 1961-1968.

17. *Reves*, 856 F2d at 53.

United States Supreme Court in *SEC v Howey Co.*[18] to determine whether the notes were a "security" under the Securities Exchange Act, and therefore, subject to the provisions of the Act.[19] The Securities Exchange Act defines a security in broad terms intended to encompass any speculative investment scheme; therefore, courts have compared the characteristics of a disputed scheme to the indicia of established securities. The Eighth Circuit examined the notes and determined that this transaction was akin to a commercial transaction, not an investment contract.[20] The court found no reasonable expectation of profit in *Reves*.[21] The notes were also found to be uncharacteristic of securities.[22] Due to the foregoing analysis, the court determined that the notes were not securities within the ambit of the Securities Exchange Act. Judgment was entered for Arthur Young.[23]

The noteholders appealed the decision of the United States Circuit Court of Appeals for the Eighth Circuit.[24] The Supreme Court addressed the issue of whether the demand notes issued by the Co-op were "securit[ies]" within the meaning of section 3(a)(10) of the Securities Exchange Act.[25] The Supreme Court reversed the decision of the Eighth Circuit, holding that the notes constitute "securit[ies]" under the Act and that the demand nature of the notes does not remove them from the scope of the Securities Exchange Act.[26]

Beginning the analysis with the definition of a "security" under section 3(a)(10), the Court laid out the letter of the law.[27] The

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18. 328 US 293 (1974).

19. *Reves*, 856 F2d at 54. See note 27 for the definition of a security under the Securities Exchange Act.

20. *Reves*, 856 F2d at 54. An investment contract is a "contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *Howey*, 328 US at 293 (internal quotations omitted).

21. *Reves*, 856 F2d at 54.

22. Id at 55.

23. Id.

24. *Reves*, 110 S Ct at 948.

25. Id. 15 USC § 77c(a)(10).

26. *Reves*, 110 S Ct at 948.

27. Id. Section 3(a)(10) of the Securities Exchange Act provides:

> [U]nless the context otherwise requires—the term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferrable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group

Court then expounded upon the purpose of the Securities Exchange Act.[28] Due to serious abuses which had occurred in the unregulated securities market,[29] the 1933-1934 Congress enacted prophylactic legislation to curb future abuses.[30] Additionally, because of the severity and incidence of indiscretions which occurred in the period preceding the stock market crash of 1929, the definition of a "security" was broadly drafted to encompass the many types of instruments which would fall within the common perception of a "security."[31] According to the Court, the definition of a security encompassed virtually any instrument which might be sold as an

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or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 USC § 78c(a)(10) (1987).

28. *Reves*, 110 S Ct at 949. See note 30 and accompanying text.

29. Law & Business, Inc., *Securities Activities of Banks* 23, 29-30 (Harcourt Brace Jovanovich 1984). Congressional inquiry revealed various abuses in the investment banking field. Among the abuses which were revealed were: (1) Banks had extended imprudent loans to securities affiliates; (2) Banks had extended imprudent loans to bank customers to facilitate the purchase of securities underwritten or distributed by the bank's securities affiliate; (3) Assets of the parent institution were used to purchase "excessive securities holdings" of the bank's securities affiliate; (4) Manipulative transactions were conducted with the stock of the parent institution by the securities affiliate; (5) Bank officers directly profited from the securities affiliates operations; (6) Securities were sold by affiliates to the parent banks and other affiliates under repurchase agreements as a means of obtaining credit; (7) Banks were purchasing securities from their affiliates in order to assure the success of their underwriting endeavors; and (8) Banks were at risk of diminished depositor confidence as a result of losses in the securities market. Id.

30. *Reves*, 110 S Ct at 949. The 1933-1934 Congress enacted three acts to regulate the investment banking/securities field. The Glass-Steagall Act, the popular name given to various provisions of the Banking Act of 1933, was intended to effectuate a complete separation of the activities of commercial bankers and investment bankers in order to fortify the commercial banking system. See Edmond Ianni, *"Security" Under the Glass—Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court's Analysis*, 100 Bank L J 100, 103 (1983). The Glass-Steagall Act is codified as amended in sundry sections of 12 USC. The Securities Act of 1933 was enacted to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof. The Securities Act of 1933 is codified as amended in 15 USC sections 77a-77aa (1982 & Supp 1987). The Securities Exchange Act of 1934 was enacted to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets. The Securities Exchange Act is codified as amended in 15 USC sections 78a-78jj (1982 & Supp 1987).

31. *Reves*, 110 S Ct at 949.

investment.[32]

The Court, however, recognized that notes[33] fall outside the class of investments which are "obviously within" the class of instruments which Congress intended to regulate and which are "by [their] nature[,] investments."[34] Demand notes, the Court concluded, require a case-by-case analysis to determine the applicability of the Securities Exchange Act.[35] Because the Securities Exchange Act was enacted to regulate investment instruments, "any note," as used in section 3(a)(10), must be considered in light of the spirit of the Act.[36]

The Supreme Court evaluated several tests to determine whether an instrument is a "security,"[37] and adopted the "family resemblance" test.[38] The "family resemblance" test was employed because it was considered to have a more substantial framework for analysis than the "investment v. commercial" test.[39] Because section 3(a)(10) includes "any note" within the ambit of the Act,

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32. Id.

33. A note is an evidence of indebtedness obligating the signor to pay a sum certain at a specified date. *Dictionary of Finance and Investment Terms* 262 (Barron's, 2d ed 1987). Notes are used in both the commercial and investment spheres.

34. *Reves*, 110 S Ct at 949. *Landreth Timber, Co v Landreth*, 471 US 681 (1985). Common stock is the paradigm of a security, which is by nature an investment, and should be treated as within the ambit of the securities laws, in whatever context common stock is sold. *Reves*, 110 S Ct at 949.

35. Id.

36. Id at 950.

37. Id at 950-51. The *Howey* test defines a security as an investment in a common enterprise with a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others. *Securities Exchange Comm v Howey Co*, 328 US 293, 299 (1946). The "risk capital test" combines the Supreme Court's focus on the "economic realities" of the transaction with its emphasis that a security involves the expectation of profits through an enterprise controlled by others. The ultimate question under the "risk capital" test is whether risk capital was contributed which is subject to the entrepreneurial or managerial efforts of others. *Underhill v Royal*, 769 F2d 1426, 1431 (9th Cir 1985). The "family resemblance test" compares the instrument in dispute to a list of instruments commonly known as notes which the Second Circuit has determined are not securities. The note in question is compared to determine whether it bears a "family resemblance" to the promulgated list of non-securities. *Exchange National Bank of Chicago v Touche Ross & Co*, 544 F2d 1126, 1138 (2d Cir 1976). The "investment v. commercial" test focuses on the degree of dependance of the contributing party on the expertise and managerial efforts of others. The applicability of the securities laws is dependant upon whether the transaction "more closely resembles" a typical investment situation or a typical commercial transaction. If the transaction closely resembles an investment transaction and there is a high degree of dependance upon the efforts of others, the securities laws are held to apply. *Futura Development Corp v Centex Corp*, 761 F2d 33 (1st Cir 1985).

38. *Reves*, 110 S Ct at 951.

39. Id. See note 37 for definition of the "investment v commercial" test.

notes are rebuttably presumed to be securities.[40] The spirit of the Act was to regulate the investment market and, therefore if an instrument is an investment it is within to the Securities Acts.[41] A list of instruments commonly known as notes, but which are outside the connotation of a "security," was promulgated by the Second Circuit.[42] The list which was set forth by the Second Circuit was examined by the Supreme Court in *Reeves* to reveal the characteristic components of the family members in order to establish a solid framework for analysis.[43] The Supreme Court analyzed the instruments according to four criteria to determine whether the notes in question constituted a "security": 1) the motivation behind the transaction; 2) the plan of distribution; 3) the common perceptions of securities; and, 4) whether mitigating factors rendered the application of the securities laws unnecessary.[44]

The Court stated that a note is presumed to be a "security."[45] However, that presumption may be rebutted by a determination that the note in question bears a strong family resemblance to the list espoused by the Second Circuit, in terms of the identified criteria.[46] The Court concluded that the demand notes sold by the Co-op did not closely resemble the promulgated non-security "family resemblance" list members. The Court went on to analyze the demand notes in terms of the four criteria which it extrapolated from the nature of the promulgated list.[47]

The criterion of motivation was first examined by the Court.[48] The transaction was assessed to discern the motivations which would prompt a reasonable buyer and seller to enter into it.[49] In *Reeves*, the Co-op sold the notes in order to raise capital for its general business practices.[50] Because the notes offered a rate of return above that paid by local financial institutions, the Court inferred that the transaction was naturally susceptible to public perception that it constituted an investment in a business enterprise.[51]

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40. *Reves*, 110 S Ct at 951.
41. Id.
42. Id at 950. See *Exchange National Bank of Chicago v Touche Ross & Co*, 544 F2d 1126, 1138 (2d Cir 1976).
43. *Reves*, 110 S Ct at 951-52.
44. Id.
45. Id at 952.
46. Id. See note 186 and accompanying text.
47. Id at 952-53.
48. *Reves*, 110 S Ct at 952.
49. Id.
50. Id at 952.
51. Id at 952-53.

The purchasers bought the notes in order to earn an interest rate above the financial market rates.[52] In light of this motivation, the Court concluded that the demand notes were an investment, rather than a commercial, transaction.[53]

The second criterion which the Court addressed was the plan of distribution.[54] The plan of distribution of the instrument was examined to determine whether it was the type of instrument in which there commonly exists trading for speculative purposes. The notes at issue were offered to both Co-op members and nonmembers over an extended period of time and at the time that the Co-op filed for bankruptcy, more than 1,600 people held notes.[55] Instruments which are in "common trading" are investment instruments.[56] The Court determined that to establish "common trading" of an instrument, an offering to a broad segment of the population must be shown.[57] The length of the period of offering and the breadth of the offering class were opined to be sufficient to establish "common trading" in this case.[58]

The third criterion considered by the Court was the common perceptions of securities.[59] The reasonable expectations of the investing public were examined to determine whether the instrument was commonly perceived to be a "security." Instruments will be considered to be securities on the basis of public expectation, even where economic analysis of the circumstances of the transaction would suggest that the instruments are not securities.[60] The Court found the rudimentary essence of a "security" to be its characteristic as an investment.[61] In the instant case, the Co-op advertised the demand notes as an investment program.[62] The note's rate of return was above the market rate of return available through financial institutions.[63] No countervailing factors were found by the Court to temper the characterization of the notes as an investment and, therefore, the Court found it reasonable for a member of the

52. Id at 952.
53. Id.
54. Id.
55. Id.
56. Id.
57. Id.
58. Id. See notes 2 to 4 and accompanying text.
59. Id.
60. Id.
61. Id.
62. Id.
63. Id.

public to perceive the demand notes as a security.[64] The final criterion examined by the Court was the existence of factors which would serve to mitigate risk.[65] The Court addressed the existence, or lack thereof, of other factors which would serve to reduce the risk of the transaction, thus rendering unnecessary application of the Securities Acts.[66] The notes in question were uncollateralized and unsecured demand promissory notes.[67] Without the application of the securities laws, these notes would escape federal regulation completely.[68] No factors were found which served to mitigate the inherent risk of the notes at issue.[69]

The lower court found that the demand notes were uncharacteristic of a "security".[70] The demand nature of the notes was held by the court to be atypical of a security.[71] Theoretically, demand notes are capable of instant liquidity;[72] instant liquidity was held to be incompatible with the nature of investments.[73]

The Supreme Court concluded that the demand feature does not eliminate risk unless and until payment is tendered to the demandant.[74] Demand notes are theoretically payable on demand.[75] In actuality, however, the demand and the transformation to cash may not be simultaneous.[76]

The Court stated that the demand notes constituted "securit[ies]" under section 3(a)(10) of the Securities Exchange Act.[77] Ernst & Young contended that these notes were exempted from the definition of a "security" due to their demand nature, even if they would otherwise constitute a "security."[78] In support of their

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64. Id.
65. Id.
66. Id.
67. Id.
68. Id.
69. Id.
70. Id.
71. Id.
72. Liquidity connotes the ability to convert a security into cash on the secondary market without a substantial drop in price of the security or the ability to convert an asset into cash. *Dictionary of Finance and Investment Terms* 213 (Barron's, 2d ed 1987).
73. *Reves*, 110 S Ct at 953.
74. Id. Common stock is the archetype of a security and stock is as readily liquid as a demand note. Common stock may be more readily liquidated than demand notes due to the virtually simultaneous redemption of the stock and receipt of the proceeds. Id.
75. Id.
76. Id.
77. Id.
78. Id. Section 3(a)(10)provides an exemption for certain instruments which would otherwise constitute a "security" and be within the ambit of the Securities Exchange Act

proposition, Ernst & Young cited Arkansas case law for the proposition that, for purposes of the statute of limitations, demand notes are at maturity when issued.[79] The maturity of a note, however, was determined by the Court to be a question of federal law.[80] The aim of the securities laws is to regulate investment transactions.[81] To read the exemption to exclude investment securities with a maturity not in excess of nine months would be inconsistent with the espoused Congressional intent.[82] The Court reaffirmed earlier decisions which had concluded that the economic reality of the transaction, not the literal words of section 3(a)(10), is the basis of determination as to whether the Securities Acts apply.[83] The plain words of the statute are not dispositive. Demand notes were also determined not to necessarily have a short maturity.[84] The exemption of notes with a maturity not in excess of nine months were determined not to encompass the demand notes at issue due to their investment nature.[85] The notes at issue here, therefore, fell within both the "note" and "security" categories of section 3(a)(10)of the Securities Exchange Act.[86]

While joining in the Majority opinion's rationale and conclusion, Justice Stevens found substantial additional support for the majority's holding in the reading of section 3(a)(10) of the Securities Exchange Act by the Courts of Appeals.[87] Where there is a settled construction of a statute, that construction should not be dis-

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were it not for the exemption. The exemption provides that the definition of a security does not encompass: "currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." 15 USC § 78c(a)(10) (1987).

79. *McMahon v O'Keefe*, 213 Ark 105, 106, 209 SW2d 449, 450 (1948) (the statute of limitations is triggered by the issuance of demand notes rather than the date of the first redemption demand).

80. *Reves*, 110 S Ct at 954.

81. Id. See note 30 and accompanying text.

82. Id.

83. Id.

84. Id at 955.

85. Id.

86. Id.

87. *Sanders v John Nuveen & Co*, 463 F2d 1075, 1080 (7th Cir 1972), cert denied, 409 US 1009 (1972) (When Congress spoke of notes with a maturity not in excess of nine months, it meant commercial paper, not investment securities). See also *Zeller v Bogue Electric Manufacturing Corp*, 476 F2d 795, 800 (2d Cir 1973), cert denied, 414 US 908 (1973); *McClure v First National Bank*, 497 F2d 490, 494 - 495 (5th Cir 1974), cert denied 420 US 130 (1975); *Halloway v Peat, Marwick, Mitchell & Co* 879 F2d 772, 778 (10th Cir 1989); *Baurer v Planning Group, Inc*, 215 U S App D C 384, 389-391, 669 F2d 770, 775-77 (D C Cir 1981).

turbed unless and until Congress decides to alter it.[88] Once interpreted by the courts, a statute acquires a meaning just as if the interpretation had been drafted by the Congress, such interpretation cannot be altered.[89] A strong interest in enabling those who are to be affected by a law to predict the legal consequences of a proposed course of action, coupled with the interest in ensuring that Congress legislates and the judiciary interprets the law, requires that a settled construction be followed.[90]

Further support for this contention was found in the espoused views of the Securities Exchange Commission, the body charged with enforcing the securities laws.[91] The Supreme Court has also referred to the section 3(a)(10) exclusion for notes with a maturity not in excess of nine months as an exclusion for commercial paper.[92] The legislative history of the Securities Exchange Act and the Securities Act of 1933 evidence that the exclusion was only meant to encompass commercial paper; the Securities Exchange Commission has construed both the Securities Exchange Act and the Securities Act in accordance with this view.[93] For the reasons espoused by the Court, and the above considerations, Justice Stevens concurred in the finding that these notes were "securities" within the ambit of the Securities Exchange Act.[94]

Chief Justice Rehnquist joined in the majority's opinion that the notes in question were "securities" within the purview of the Securities Exchange Act.[95] Chief Justice Rehnquist dissented, however, from the Court's exclusion of the demand notes from the exemption for notes with a maturity not in excess of nine months.[96] Chief Justice Rehnquist advocated that, in construing the meaning of words which are susceptible to more than one plausible construction, the common understanding which existed at the time of

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88. *Reves*, 110 S Ct at 956.

89. Id.

90. Id.

91. Id. See *Securities and Exchange Commsn*, Release No 33-4412, 26 Fed Reg 9158 (1961).

92. *Reves*, 110 S Ct at 956. *SIA v Bd of Governors*, 468 US 137, 150-152 (1984). Commercial paper is a negotiable instrument or unsecured, short-term promissory note issued by a corporation to solve a short term liquidity deficiency. *Dictionary of Finance and Investment Terms* 68 (Barron's, 2d ed 1987).

93. *Reves*, 110 S Ct at 957.

94. Id.

95. Id.

96. Id. Justices White, O'Connor and Scalia joined in the dissenting opinion of Chief Justice Rehnquist.

the drafting of the securities laws must be examined.[97] Contemporaneous editions of legal dictionaries and caselaw revealed a prevalent comprehension in 1933 that demand notes were mature when issued.[98] The maturity date exemption, concluded the Chief Justice, encompassed demand notes, thus removing notes from the scope of the Securities Exchange Act.[99]

The Chief Justice noted that Justice Stevens relied on the legislative history of the Securities Act to support his contention that the 1934 Securities Exchange Act exclusion for notes with a maturity not in excess of nine months encompassed only commercial paper.[100] In the Chief Justice's view, the legislative history of the 1934 Act does not support this contention.[101] Furthermore, the restrictive nature of the exclusion is not evidenced to have survived the enactment of the securities laws.[102] The Chief Justice also noted that the enacted language was broader than the proposed language, evidencing an intent to afford an exemption to all notes with a maturity of nine months or less.[103] The exemption relied upon in the Securities Act exempts the instruments from registration under the Act, but they are still subject to the Act's anti-fraud provisions.[104] The exemption in section 3(a)(10) of the 1934 Act exempts instruments covered by the exclusion from the entirety of the Act.[105] The Chief Justice further concluded that the reading of the exemption as one contextual exception does not render the context clause superfluous, as Justice Stevens asserted.[106] This reading merely delineates one exemption, with the courts free to flesh out the additional contextual exemptions.[107]

Because Justice Rehnquist could find no justification for looking beyond the literal words of section 3(a)(10), he concluded that demand notes, due to their maturity upon issuance, were excluded

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97. Id.

98. Id at 957-58.

99. Id at 958.

100. Id.

101. Id. See Securities and Exchange Commsn, Release No 33-4412, 26 Fed Reg 9158, 9159 (1961) (interpretation of section 3(a)(3) of Securities Act of 1933); *Marine Bank v Weaver*, 455 US 551, 555-56 (1982); *SIA v Bd of Governers*, 468 US 137, 150-52 (1984).

102. *Reves*, 110 S Ct at 958.

103. Id.

104. Id. The anti-fraud provisions are found in section 10(b), 15 USC § 78j(b) (1982). See note 14 and accompanying text.

105. *Reves*, 110 S Ct at 959.

106. Id.

107. Id.

from the ambit of the Securities Exchange Act.[108] The dissenters would have upheld the decision of the Court of Appeals.[109]

In 1931 and 1932 the Senate Banking Committee conducted investigations into the banking industry in the United States. A congressional investigation of the securities market was conducted in 1933. The results of these investigations were numerous reports of perceived abuses in the financial market.[110] The committee hypothesized that "speculation in weak securities" played a significant role in causing the depression.[111]

The 1933-34 Congress enacted three acts to regulate the investment banking/securities field.[112] The Glass-Steagall Act, the popular name given to various provisions of the Banking Act of 1933, was intended to effectuate a complete separation of the activities of commercial bankers and investment bankers in order to fortify the commercial banking system.[113] The Securities Act of 1933 was enacted to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale of such securities.[114] The Securities Exchange Act of 1934 extended the protection underlying the Securities Act to securities listed and registered for public trading. The Securities Exchange Act of 1934 was enacted to provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets.[115] The Securities Exchange Act attempts to deal with three principal problems: "the excessive use of credit for speculation, the unfair practices employed in speculation, and the secrecy surrounding the financial condition of corpo-

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108. Id at 960.

109. Id.

110. Raymond Natter, *Glass - Steagall Act Reform: The Next Banking Issue on the Congressional Agenda*, 35 Federal Bar News & Journal 185, 186 (1988). See also Law & Business *Securities Activities of Banks*, 29-30 (Harcourt Brace Jovanovich 1984).

111. Natter, 35 Federal Bar News & Journal at 186 (cited in note 110). See also Comment, *Expansion of National Bank Powers: Regulatory and Judicial Precedent Under the National Bank Act, Glass-Steagall Act, and Bank Holding Company Act*, 36 SW L J 765, 779 (1982).

112. Ianni, *"Security" Under the Glass-Steagall Act and the Federal Securities Acts of 1933 and 1934: The Direction of the Supreme Court's Analysis.* 100 Bank L J 100, 103, 121 (cited in note 30).

113. Id.

114. See Preamble of the Securities Act of 1933, Pub L No 22 48 Stat 74 (1933), codified at 15 USC § 77(a) (1982).

115. Securities Exchange Act of 1934, Pub L No 291 (Preamble & section 2, 15 USC § 78b).

rations which invite the public to purchase their securities."[116]

The Glass-Steagall Act, the Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted in response to similar problems, but each has a unique orientation. The Securities Act and Securities Exchange Act require only that investors be fully appraised of all material information prior to assuming a speculative risk.[117] They do not prohibit the assumption of speculative risk.[118] The Glass-Steagall Act prohibits commercial banks from assuming speculative risks of securities, insulating depository funds from speculative risk.[119] Each Act is designed to remedy a different problem which was inherent in the financial market prior to its enactment.[120]

A substantial amount of litigation has arisen under the New Deal securities laws.[121] The Securities Acts contain a broad definition of "security, which calls for a case-by-case analysis in most circumstances. The Glass-Steagall Act contains no definition of a "security," but as the Securities Act was passed a fortnight later, the definition of the Securities Act is used by the courts when dealing with an issue under the Glass-Steagall Act.[122]

The development of the analysis under the Securities Acts has evidenced a championing of "substance-over-form." The economic realities of a transaction dictate the applicability of the Acts, as opposed to the nomenclature used.[123]

SEC v Joiner Corp.[124] established a contextual framework of analysis of a "security" under the 1933 Act. An action was brought by the Securities and Exchange Commission (hereinafter, "SEC") to restrain the Joiner Corporation from further violations of sec-

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116. See S Rep 792, 73d Cong, 2d Sess (1934).

117. Ianni, 100 Bank L J at 121-22 (cited in note 30).

118. Id at 122.

119. Id at 122-23.

120. See note 30 and accompanying text.

121. See note 123 and accompanying text.

122. *A.G. Becker, Inc. v Bd of Governors*, 519 F Supp 602 (D DC 1981), rev'd, 693 F2d 136, rev'd as *SIA v Bd of Governors* 468 US 137, 150-51 (1984).

123. See *SEC v Joiner Corp.*, 320 US 344 (1943); *SEC v Howey Co*, 328 US 293 (1946); *Tcherepnin v Knight*, 389 US 332 (1967); *McClure v First National Bank of Lubbock, Texas*, 497 F2d 490 (5th Cir 1974); *United Housing Foundation, Inc. v Forman*, 421 US 837 (1975); *Exchange National Bank v Touche Ross & Co.*, 544 F2d 1126 (2d Cir 1976); *Marine Bank v Weaver*, 455 US 551 (1982); *SIA v Bd of Governors*, 468 US 137 (1984); *Hunssinger v Rockford Business Credits*, 745 F2d 484 (7th Cir 1984); *Chemical Bank v Arthur Anderson Co.*, 726 F2d 930 (2d Cir 1984) ; *Landreth Timber Co. v Landreth*, 471 US 681 (1985) ; *Futura Development Corp.v Centex Corp.*, 761 F2d 33 (1st Cir 1985); *Underhill v Royal*, 769 F2d 1426 (9th Cir 1985).

124. 320 US 344 (1943)

tions 5(a) and 17(a)(2) and (3) of the Securities Act of 1933.[125] *Joiner* engaged in a campaign to sell assignments of oil leases with a corresponding service contract.[126]

The Supreme Court, per Justice Jackson, opined that the test to determine whether an instrument is within the scope of the Securities Act is the "character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect."[127] Documents in which there is common trading for a speculative or investment purpose were included within the ambit of the Securities Acts. If the instrument is an investment in substance, it falls under the Acts due to its inherent risk. If the offering class is sufficiently broad, the instrument also embodies the dangers sought to be prevented by the Securities Acts. The Supreme Court determined that the assignments of oil leases which were sold by Joiner constituted an "investment contract" and an interest or instrument commonly known as a "security."[128]

The terms of the lease created a form of investment contract because the purchaser was paying both for a lease and for a development project.[129] Because the oil survey venture was enmeshed in these leases in both an economic and legal sense the defendants were held to be offered more than naked leasehold rights.[130] The economic interest in drilling furnished a substantial portion of the value of the instruments sold. The drilling venture conducted by Joiner gave the purchase its allure.[131] Trading in this endeavor had all the evils inherent in the securities transactions that the Securities Act was intended to eviscerate.[132]

The rules of statutory construction which were advanced to show that the instruments in question were outside the purview of section 2(1) of the Securities Act were rejected by the Court[133] be-

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125. 320 US at 345. Section 5a is codified as amended in 15 USC § 77e. Sections 17(a)(2) and (3) are codified as amended in 15 USC § 77q.

126. *Joiner*, 320 US at 345.

127. Id at 352-53.

128. Id at 351, 354.

129. Id.

130. Id.

131. Id.

132. Id.

133. Id. Joiner espoused an adherence to "ejusdem generis" (to condense the more general terms to include only those which are substantially similar to the specific terms which follow) and to "expressio unius est exclusio alterius" (to show that the absence of an express inclusion constitutes its exclusion where the statute in question makes explicit reference to other instruments). Id at 350.

cause the legislative purpose for enacting the Securities Act was deemed to champion over canons of statutory construction.[134] The definition of a "security" was drafted to include by name or description many instruments or schemes in which there is common trading for speculation or investment.[135] Excising or constricting the broad definitional terms to include only those instruments which substantially conform to the specified instruments listed in section 2(1) would render the general terms superfluous.[136] If an instrument is established to be an investment contract or a holding or instrument commonly known as a security, they are brought within the ambit of the Acts.[137]

SEC v Howey Co.,[138] decided two-and-a-half years after *Joiner*, established the definition of an "investment contract" for purposes of the 1933 Act. *Howey* involved a suit by the Securities and Exchange Commission to enjoin the Howey Co. from using the "mails and instrumentalities of interstate commerce in the offer and sale of unregistered and non-exempt securities in violation of § 5(a) of the Act."[139]

The Securities Act does not define an "investment contract."[140] An "investment contract" had been judicially defined prior to the enactment of the Securities Act to encompass a contract or scheme which extends capital or money to secure income or profit from its employment in a venture.[141] The pre-existing judicial interpretation of the term had infused meaning to the term "investment contract."[142] That interpretation comports with the intent of the Securities Act.[143] This definition was determined to embody the necessary flexibility capable of encompassing the myriad possible schemes seeking to use third party capital to bring profit.[144] The

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134. Id at 351.

135. Id.

136. Id.

137. Id.

138. 328 US 293 (1946).

139. Id at 294.

140. Id at 298.

141. Id. See also, *State v Gopher Tire & Rubber Co*, 146 Minn 52, 56, 177 NW 937, 938 (1920).

142. *Howey*, 328 US at 298.

143. Id. The court defined an investment contract as: "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise." Id at 298-99.

144. Id at 299.

term was broadly construed to afford investors a substantial degree of protection.[145] The transactions in question were found to be the paradigm of an "investment contract" under the promulgated definition.[146]

The Howey Co. offered an opportunity to contribute funds to a pool of assets and to share in the profits of the enterprise collectively managed and partly owned by the Howey Co.[147] The integral "elements of a profit-seeking business venture" were found to be present.[148] The scheme in question involved the investment of capital in a common enterprise, investors were not afforded any voice in the management and the profits were to come solely from the efforts of others. The plan was determined to fall within the category of an "investment contract" under the Securities Acts.[149]

The Court extended its focus on the substance of the transaction and the "investment contract" test espoused by the *Howey* Court (under the 1933 Act) to the 1934 Act in *Tcherepnin v Knight*.[150] In that case, holders of withdrawable capital shares in City Savings Association of Chicago filed a class action suit on behalf of more than 5,000 investors,[151] alleging that the sale of the capital shares was void under section 29(b) of the Securities Exchange Act of 1934[152] because the capital shares constituted a security under section 3(a)(10).[153] In an attempt to develop the definition of a security under the Securities Exchange Act, the Supreme Court relied on the settled definition of a security under the Securities Act.[154]

The Supreme Court determined that the withdrawable capital shares most closely resembled an "investment contract".[155] The program was found to involve investment in a common enterprise

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145. Id.

146. Id.

147. Id.

148. Id at 300.

149. Id.

150. 389 US 332 (1975).

151. *Tcherepnin*, 389 US at 333, n.2.

152. Id. Section 29(b) is codified as amended at 15 USC section 78cc(b), which states that any contract made in violation of the Securities Act is void. 15 USC § 78cc(b) (1987).

153. Id. Codified at 15 USC § 78c(a)(10) (1987).

154. *Tcherepnin*, 389 US at 336. Because the same Congress had passed both Acts and the legislative history of the 1934 Act asserts that the 1933 Act definition of a security was "substantially the same" as the 1934 Act, the Court utilized the established definition under the 1933 Act, which was also used in *SEC v Howey* and *SEC v Joiner*. Id at 336, 342.

155. Id at 336. The withdrawable capital shares were found to also constitute "certificate[s] of interest or participation in any profit-sharing agreement," "stock" or "transferrable shares." Id at 339-40.

with profits to come solely from the efforts of others.[156] The totality of the savings and loan's assets were derived from the issuance of these instruments, evidencing an offering to a broad class. Because the return on the initial investment was dependent upon the profits of the association, it was a speculative venture.[157] The essential characteristics of an "investment contract" were found to exist in this enterprise; the Securities Acts were, therefore, determined to govern the venture.[158]

McClure v First National Bank of Lubbock, Texas[159] further honed the "investment/commercial" analysis. The United States Court of Appeals for the Fifth Circuit faced the issues of whether a promissory note, which is given jointly with a trust deed for a bank loan, constitutes a security under the Securities Acts and, whether the commitment of corporate stock for renewal of a bank loan constitutes a sale under the Securities Acts.[160]

The Fifth Circuit determined that the Act was inapplicable because the transactions in question involved commercial, not investment, transactions.[161] The Bank and the Corporation were involved in the exchange of collateral related to a commercial loan. The notes were not offered to a class of investors, nor were they acquired by the lender for any speculative purpose.[162] The corporation did not receive investment capital in return for its notes.[163] The nature of the note was held to control the applicability of the Act.[164] The exemption based upon maturity length was not considered. The sole question which was addressed was the nature of the instrument.[165] The exemption for notes with a maturity not in excess of nine months became surplus verbiage.[166]

The second argument advanced by the petitioner was that her

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156. Id at 338 (quoting *SEC v Howey*, 328 US at 293, 298).

157. *Tcherepnin*, 389 US at 338.

158. Id at 339.

159. 497 F2d 490 (5th Cir 1974).

160. *McClure*, 497 F2d at 491.

161. Id. The court "realize[d] that [its] holding . . . virtually writes the exemption [for notes with a maturity not in excess of nine months] out of the law" in the Fifth Circuit. Id. Commercial notes were determined to be outside of the ambit of the Act, regardless of their term of maturity. The exemption for investment paper with a maturity of less than nine months had previously been rendered void by prior judicial decision. When the precedential caselaw was coupled with the exclusion for commercial notes, regardless of their term of maturity, the exemption was rendered superfluous. Id.

162. Id at 492.

163. Id.

164. Id at 495.

165. Id at 492-93.

166. Id at 495.

pledge of corporate stock in consideration for renewal of the loan constituted a sale of a security, and, therefore, should have been afforded the protection of the Securities Exchange Act. The court also rejected this argument.[167]

United Housing Foundation v Forman[168] followed the guiding principal set forth in *Joiner*, *Howey*, and *Tcherepnin*. The Court's focus was on the substance and economic reality of the underlying transaction. Co-op City was a cooperative housing project for low cost housing, which sold "shares" of "stock" to prospective apartment purchasers.[169] Fifty-seven residents brought suit on their own behalf and on behalf of the housing corporation, alleging violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 in connection with the sale of the "shares" of "stock" in the cooperative.[170]

Although the shares were designated as "securities," the Court concluded, they exhibited none of the characteristics which are commonly attributable to "stock."[171] The Supreme Court held that, in defining a "security" under the Securities Acts,[172] Congress was seeking to broadly define the term to allow flexibility of application where appropriate.[173] The shares purchased by the residents were determined "not [to] represent any of the 'countless and vari-

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167. Id. The acceptance by a creditor of a stock pledge as collateral in a privately negotiated transaction does not bring a transaction which is outside the ambit of the Securities Acts within their scope. Id. The court examined decisions under the Securities Act of 1933 which ruled that "the pledge of unregistered stock as loan collateral is a 'sale,' "however, all of the decisions involved the subsequent sale of the pledged securities following the default of the covenanting party. The subsequent foreclosure and sale of pledged securities forced the bank to assume the role of a securities underwriter. Without a foreclosure and resultant sale, the pledge of stocks does not constitute a "sale" under section 10(b) of the Securities Exchange Act of 1934. Id.

168. 421 US 837 (1975).

169. *Forman*, 421 US at 838.

170. Id.

171. Id. The instruments at issue did not possess the characteristics of negotiability or proportional voting rights, nor the right to receive dividends, the right to pledge or encumber the interest, or to gain access to a secondary market in order to sell the instrument. The stock in this case was not speculative in nature. Id. Typically, shares of stock are evidences of ownership of a corporation represented by shares that are a claim on the corporation's earnings and assets. Holders are entitled to vote on the selection of directors and other important matters. Voting rights are conferred based upon the number of outstanding shares held. Holders are also entitled to a proportionate distribution of dividends if and when they are distributed. Stock is freely negotiable and transferrable on the secondary market. *Dictionary of Finance and Investment Terms* 399-400 (Barron's, 2d ed 1987).

172. *Forman*, 421 US at 847. The Court treated the definition of a security and the coverage of both of the Securities Acts the same. Id.

173. Id. See H R No 85, 73d Cong, 1st Sess 11 (1933).

able schemes devised by those who seek the use of money of others on the promise of profits' . . . and therefore do not fall within 'the ordinary concept of a security'."[174] The Securities Acts were designed to serve as a prophylactic against abuses in the previously unregulated securities market.[175]

The Court defined the distinguishing factor between investment contracts or securities and a commercial endeavor, which is outside the scope of the Securities Acts, as whether the scheme involves an investment of money in a common enterprise with profits derived solely from the efforts of third parties.[176] In *Forman*, the impetus to acquire the shares in question was to obtain low cost housing and was not motivated by an expectation of profit.[177] The profit motive inherent in a security was absent in this case.[178]

Exchange National Bank v Touche Ross & Co.[179] further cultivated the "investment/commercial" distinction by way of a comparison of the disputed instruments to notes which are outside the coverage of the Securities Acts due to their commercial nature (the "Family Resemblence test"). Exchange National Bank purchased three unsecured[180] subordinated[181] demand notes[182] from a New York Brokerage firm.[183] Violations of both the Securities Act of 1933 and the Securities Exchange Act of 1934 were alleged by Exchange National Bank.[184]

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174. *Forman*, 421 US at 848 (citing *Howey*, 328 US at 299).

175. *Forman*, 421 US at 849. The concentration of the Securities Acts is "on the capital market . . . the sale of securities to raise capital for profit-making purposes, the exchanges on which the securities are traded, and the need for regulation to prevent fraud and to protect the interest of investors." Id.

176. Id at 852. See also, *Howey*, 328 US at 301.

177. *Forman*, 421 US at 853.

178. Id at 858. Here the shares were a personal consumption expenditure. Id.

179. 544 F2d 1126 (2d Cir 1976).

180. Id. The notes were not backed by assets pledged to assure repayment of the debt. *Dictionary of Finance and Investment Terms* 458 (Barron's, 2d ed 1987).

181. *Exchange National Bank*, 544 F2d at 1126. The claims were subject to a superior lien of another creditor and, therefore, were entitled to satisfaction only after the satisfaction of the superior lien. *Dictionary of Finance and Investment Terms* 409 (Barron's, 2d ed 1987).

182. *Exchange National Bank*, 544 F2d at 1126. The notes were payable upon written demand "at least six (6) months prior to [the maturity] date, or upon such date thereafter as may be specified by the lender upon written demand" received at least six months prior to the demand date. Id at 1128.

183. Id. The notes were to reach maturity one year, one year and three months, and one year and six months after the purchase respectively. Id.

184. Id at 1127. The alleged violations included an allegation of the breach of section 17(a) of the Securities Act, sections 10(b), 18(a), 15(c) and 17(a) of the Securities Exchange Act, SEC Rule 10-b and a pendent state claim for negligence. Id. The claim is based upon

The "family resemblance" test espoused by the United States Court of Appeals for the Second Circuit began with a presumption that any note is a security.[185] The presumption can be rebutted by evidencing that the note in question bears a strong family resemblance to a list of enumerated notes which would fall outside the ambit of a "security" under the Securities Acts.[186] All of the list members fall within the commercial sphere. The list members are evidenced by private negotiability for a set amount which is not subject to the efforts of a third party and are not speculative by nature. To determine whether a note which has a maturity in excess of nine months constitutes a security for the purposes of the Securities Acts, the note in question was compared by the Court to the espoused list.[187] The Court stated that if the note does not bear a strong family resemblance to these examples, section 10(b) of the 1934 Act should apply.[188] Following the "family resemblence" test and finding no strong resemblance to the promulgated list, the circuit court determined that the transaction in question was subject to the coverage of the Securities Acts.[189]

The Supreme Court focused on the regulatory aspect of the Securities Acts in *Marine Bank v Weaver*.[190] The Court noted the regulatory power of the banking laws as a reason for defining a certificate of deposit (hereinafter, "CD") as outside the reach of the Securities Acts.[191] At issue was the purchase of a CD which was later pledged to the Marine Bank to guarantee a loan issued to a third party, against which the bank had a pre-existing debt.[192] The plaintiffs alleged that the bank misrepresented the proposed use for the third party loan without their knowledge, and thereby vio-

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conduct of Touche Ross as the accounting firm for the brokerage firm. Id at 1128.

185. *Reves*, 110 S Ct at 952.

186. *Exchange National Bank*, 544 F2d at 1138. The notes which do not constitute "securities" consists of "the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a 'character' loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business : . ." Id.

187. *Reves*, 110 S Ct at 952-53.

188. Id.

189. *Exchange National Bank*, 544 F2d at 1138-39.

190. 455 US 551 (1982).

191. *Weaver*, 455 US at 558. A certificate of deposit is a debt instrument issued by a bank that usually pays interest at a rate which is set by the financial market. Maturity can range from a few months to years. *Dictionary of Finance and Investment Terms* 59-60 (Barron's, 2d ed 1987).

192. *Weaver*, 455 US at 553.

lated section 10(b) of the Securities Exchange Act.[193]

The Supreme Court examined the nature of the transaction and its economic attributes and found that the CD was not within the ambit of the securities laws.[194] The holder of a CD is guaranteed payment by the FDIC, whereas other long term debts assume the risk of default by the borrower.[195] Finding adequate protection under the banking laws, the Court found no necessity to subject issuers of CD's to the provisions of the Securities Acts.[196] The CD was accordingly found to be outside the scope of the Securities Acts.[197]

Subsequently, another issue involving the sale of commercial paper came before the Court in *SIA v Bd of Governors*.[198] Bankers Trust began functioning as an agent for several of its corporate customers in marketing their commercial paper.[199] The Securities Industry Association (SIA) asserted that the merchandising of third-party commercial paper constituted a breach of sections 16 and 21 of the Glass-Steagall Act.[200]

The Supreme Court asserted that the emphasis on the fact that commercial paper was a relatively low risk instrument, that commercial banks had traditionally purchased commercial paper for their own accounts, and that commercial paper was chiefly sold to a sophisticated class of investors was misguided.[201] The safety of a particular investment was not the determining factor as to the underwriting prohibitions enacted by Congress.[202] Exceptions were

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193. Id at 554.

194. Id at 558-59.

195. Id at 558.

196. Id at 559.

197. Id. The Court opined that this agreement was also not the type of instrument that comes to mind when the term 'security' was used and, therefore, it did not fall within the common perception of a security which would be subject to the Securities Acts. Id at 559-60.

198. 519 F Supp 602 (D DC 1981), rev'd 693 F2d 136, rev'd as *SIA v Bd of Governors*, 468 US 137 (1984).

199. *SIA*, 468 US at 140. Commercial paper refers generally to negotiable instruments or unsecured, short-term promissory notes issued by corporations to solve short-term liquidity deficiencies. *Dictionary of Finance and Investment Terms* 68 (Barron's, 2d ed 1987).

200. *SIA*, 468 US at 140. Sections 16 and 21 of the Glass-Steagall Act separate banking from securities on a transactional level. Although section 16 applies only to national banks by its terms, section 5(c) of the Glass-Steagall Act provides that: "[s]tate [Federal Reserve] member banks shall be subject to the same limitations and conditions . . . as are applicable . . . [to] national banks" under section 16. 12 USC § 335 (1988). Bankers Trust Co. was a state commercial bank which was a Federal Reserve System member and, therefore, subject to the Glass-Steagall Act. *SIA*, 468 US at 137, 148.

201. Id at 158.

202. Id at 156-57.

not accorded to sophisticated investors or purchasers.[203] The Supreme Court declared that "the Act's . . . prohibition on underwriting reflects Congress' conclusion that the mere existence of a securities operation, 'no matter how carefully and conservatively run, is inconsistent with the best interests of the bank as a whole."[204]

The Court conceded that one of the impetuses behind the Glass-Steagall Act was to re-channel bank investments toward more short-term innocuous investments.[205] However, only the investment in commercial paper by a commercial bank was countenanced, not the underwriting thereof.[206]

The Supreme Court's focus was section 16 of the Glass-Steagall Act, which provides in part that the "business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account."[207]

The Court found that national banks are prohibited from underwriting any issue of securities or stock under section 16 and that section 21 prohibits any corporation which is engaged in selling, underwriting, issuing, or distributing stocks, bonds, debentures, notes, or other securities from engaging in banking activities.[208] As a depositary, the prohibitions of both sections were apropos.[209] The Court held that if commercial paper constituted a "security," its underwriting would be an illegal activity for a bank.[210]

The Glass-Steagall Act does not define "notes" or "securities." The Court reasoned that the prosaic meaning of the terms, "as used by the 1933 Congress[,] encompasses commercial paper."[211] Reading the Glass-Steagall Act in para materia with the Banking

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203. Id at 159.

204. Id at 157, quoting 75 Cong Rec 9913 (1932) (remarks of Sen. Bulkey, quoting a statement issued by the Bank of Manhattan Trust Co.). See also, Harvey L. Pitt, 1 *The Law of Financial Services* 321-22 (1988 & Supp 1990-92).

205. *SIA*, 468 US at 142.

206. Id at 157. Underwriting involves an agreement made prior to the issuance of shares of stock that a set number of shares will be guaranteed. *Dictionary of Finance and Investment Terms*, 451-52 (Barron's, 2d ed 1987).

207. 12 USC § 24 (1984).

208. *SIA*, 468 US at 157. Section 16, germane solely to national banks by its terms, is made applicable to state banks which are members of the Federal Reserve System through the operation of section 5 (c) of the Act (12 USC § 335 (1982)). *SIA*, 468 US at 148-49.

209. *SIA*, 468 US at 148-49.

210. Id at 149.

211. Id at 150.

Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934, it was determined to be evident that commercial paper was encompassed within the term security.[212] In each of the above acts, "security" includes commercial paper within its denotation. Explicit exceptions exempted commercial paper in some situations.[213] The exempting of commercial paper from the scope of the above acts under specific circumstances demonstrates a congressional understanding that commercial paper falls within the ambit of "security."[214] The underwriting of third party commercial paper is, therefore, a prohibited activity for a bank under sections 16 and 21 of the Glass-Steagall Act.[215]

In *Hunssinger v Rockford Business Credits*, the Seventh Circuit Court reinforced the necessity to look beyond nomenclature to the circumstances of the questioned transaction.[216] A purchaser filed suit alleging violation of sections 5 and 12 of the 1933 Act and section 10(b) of the 1934 Act.[217] Rockford Business Credits sold notes which had a maturity term of one year and a fixed rate of interest to the general public.[218] Each note was part of a larger capital offering and the notes were referred to as investments in communications by the seller.[219]

The United States Court of Appeals for the Seventh Circuit held that neither the fact that the return is a floating rate of interest[220] nor the short maturity term of one year is dispositive.[221] The determining factor is the substance of the transaction. The transaction at issue was determined to have none of the "paradigms of a commercial loan."[222] Public solicitation of persons seeking a passive return on a capital outlay and the sale of units in a larger offering were stated to constitute hallmarks of an investment transaction.[223] Rockford Business Credits also referred to the transaction as an investment repeatedly in correspondence.[224] A reasonable

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212. Id at 150-51.
213. Id at 151, n. 7. See 15 USC § 77c(a)(3).
214. *SIA*, 468 US at 160.
215. Id.
216. 745 F2d 484 (7th Cir 1984).
217. *Hunssinger*, 745 F2d at 487. Section 12 is codified as amended in 15 USC § 77l.
218. Id.
219. Id.
220. *Hunssinger*, 745 F2d 486. The rate of interest was a floating rate which was calculated upon the prime rate on a monthly basis. Id.
221. Id at 492.
222. Id at 493.
223. Id at 492.
224. Id at 493.

man could justifiably assume that the Securities Acts were applicable.[225] The court held that the notes in question, therefore, fall within the purview of the Securities Acts.[226]

The "sale of business" doctrine and the requirement of dependance upon the efforts of a third party to obtain a profit return was renounced in *Landreth Timber Co. v Landreth*.[227] All of the outstanding stock of a lumber company was privately owned.[228] The outstanding stock was sold and the Landreth Timber Co. was formed.[229] The purchasers later sold the mill at a loss and went into receivership.[230] The purchasers brought suit, alleging a violation of the Securities Act of 1933 by failing to register stock which had been widely offered.[231] A violation of the Securities Exchange Act of 1934 was also alleged due to perceived misrepresentations concerning the stock.[232]

The Supreme Court opined that the stock which was involved "possesses all of the characteristics . . . identified in *Forman* as traditionally associated with common stock."[233] The context of the transaction in question, however, unlike that which was involved in *Forman*, is a paradigm of the type of context in which the "Acts normally apply."[234] It is plausible in this circumstance that the purchaser would reasonably believe the Securities Acts to govern the exchange, and under the circumstances, the plain meaning of the statutory denotation should be determinative.[235] The stock should be considered to be subject to the coverage of the Securities

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225. Id.

226. Id.

227. 471 US 681 (1985). A large number of courts had previously held that the Securities Acts are inapplicable where 100% of the stock of a closely-held corporation was sold, because the purchaser did not enter the transaction with the expectation of profit stemming from the efforts of others. The transaction, therefore, was held to constitute a commercial venture rather than a typical investment, because managerial control was transferred to the purchasers. See *United Housing Foundation v Forman*, 421 US 837 (1985) and *SEC v Howey Co.*, 328 US 293 (1946). *Landreth*, 471 US at 685.

228. Id at 683.

229. Id.

230. Id. Receivership is a form of bankruptcy whereby a court-appointed person takes possession of, but not title to, the assets or affairs of the business. The court appointed Receiver collects the income and rents and manages the assets for the benefit of the owners and creditors until the court enters a disposition. *Dictionary of Finance and Investment Terms* 327 (Barron's, 2d ed 1987).

231. *Landreth*, 471 US at 683.

232. Id.

233. Id at 687.

234. Id.

235. Id.

Acts.[236]

The Court went on to examine the contention that it should address the economic substance of the transaction to determine whether the *Howey* test had been met.[237] The stock in question, however, was espoused to be blatantly within the statutory definition, so as to render further analysis unnecessary.[238] The Court found no reason to look beyond the characteristics of the instrument.[239]

In *Futura Development v Centex*,[240] the United States Court of Appeals for the First Circuit examined the various tests which were espoused by sundry other circuits to determine the presence of a "security."[241] The "investment/commercial" test was adopted due to the belief that it could best effectuate the inherent goals of the Securities Acts.[242] Futura entered into an agreement to purchase an undeveloped tract of land from Chestnut, a wholly-owned subsidiary of Centex.[243] Futura agreed to release a portion of the property (hereinafter, "Section One") to Chestnut without any further payment.[244] Other portions were to be released upon the payment of a specified sum per plot.[245] Chestnut defaulted on the first installment due on the promissory note.[246] According to the affidavit of Futura's Executive Vice-President, Centex agreed to assume and guarantee payment.[247] Section One was then released and Chestnut immediately retired the mortgage on the Sec-

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236. Id.

237. Id at 690. The Court has previously looked to the "economic realities of the transaction, rather than the label attached to the instrument to demarcate the scope and coverage of the Securities Acts. See *United Housing Foundation v Forman*, 421 US 837 (1985), *SEC v Joiner Corp.*, 320 US 344 (1943), and *SEC v Howey Co.*, 328 US 293 (1946). *Landreth*, 471 US at 688-89.

238. Id at 690. Stock in its traditional form "represents to many people, both trained and untrained in business matters, the paradigm of a security." Id at 693, citing *Daily v Morgan*, 701 F2d 496 (5th Cir 1983) (internal quotation omitted). Stock "is so quintessentially a security as to foreclose further analysis." Id at 694 (citing L. Loss, *Fundamentals of Securities Regulation* 211-12 (1983)) (internal quotation omitted).

239. *Landreth*, 471 US at 690.

240. 761 F2d 33 (1st Cir 1985).

241. *Futura*, 761 F2d at 39-41. See note 37 and accompanying text.

242. *Futura* 761 F2d at 39-40.

243. Id at 36. The purchase price was tendered subject to a tri-partied agreement: a portion was to be a cash settlement; Chestnut was to assume the outstanding mortgage; and Chestnut surrendered the remaining portion by a nonrecourse promissory note secured by a mortgage. Id.

244. Id.

245. Id.

246. Id.

247. Id.

tion One acreage.[248] Chestnut subsequently defaulted on the second installment due under the promissory note.[249]

Futura filed an action in contract fifteen months after the first default, three months after the default on the second installment, to collect the outstanding principal and interest due.[250] The trial court[251] held that the only available remedy lay in foreclosure of the remaining tract (Section Two). The Puerto Rico Supreme Court affirmed.[252]

Later, Futura filed suit in the federal district court, alleging fraud under the Securities Acts.[253] Futura alleged that Chestnut represented it was interested in the acquisition of the entire tract, but was in fact only interested in Section One.[254]

The "investment/commercial" test was adopted by the First Circuit, due to the belief that the test could best effectuate the inherent goal of the Securities Acts because "it focuses on the investor's dependency upon the efforts of the others."[255] The fact that the note was negotiated between the parties, was for a definite amount, had a set rate of interest, and that the value was independent of the efforts of Chestnut strongly suggested that the context of the transaction was a commercial, rather than an investment transaction.[256] The note was therefore determined to be outside the scope of the Securities Acts.[257]

Underhill v Royal[258] also involved a refinement of the focus on the "economic realities" of the instrument. Two companies were founded by Royal.[259] The National Mortgage Exchange (hereinafter, "NME") established franchises for a mortgage brokerage business. The National Mortgage Exchange of Southern California (hereinafter, "NMESC") was also active as a mortgage broker, but additionally operated a loan agreement program. NMESC entered into a franchise agreement with NME, whereby it was authorized

248. Id at 36-37.
249. Id at 37.
250. Id.
251. Id. Suit was filed in the Puerto Rico Superior Court. Id.
252. Id.
253. Id.
254. Id at 38. Prior to the sales contract for the entire region, Chestnut had attempted to negotiate for the purchase of Section One alone. Futura refused, believing that the property was worth more as a totality than subdivided. Id at 35-6.
255. Id at 40.
256. Id at 41.
257. Id at 42.
258. 769 F2d 1426 (9th Cir 1985).
259. *Royal*, 769 F2d at 1429.

to operate under the name of NME in its mortgage brokerage business.[260] The loan agreement program[261] was advertised over the radio, in newspapers, and in brochures which were distributed by NMESC.[262] The brochures advertised a ten percent return on principal. The brochures were replete with references to the NME, but the sole reference to the NMESC was at the end, under the signatures of the officers of NMESC. The plan was designed to restrict sales to residents of California, in order to avoid the registration requirements of the federal securities laws.[263] Some of the investors were from other states, however.[264]

NMESC filed for bankruptcy and the noteholders were deemed to be unsecured creditors.[265] Following the Chapter 11 filing, a noteholder brought suit alleging failure to register the securities pursuant to the federal Securities Acts, and violation of the antifraud provisions of the Securities Acts.[266] The complainants objected to the reorganization plan which was approved by the majority of other noteholders.[267]

The United States Court of Appeals for the Ninth Circuit held that the nature of the Secured Contractual Loan Program evidenced a representation to a wide basis of the public of a prearranged plan to create a general fund to invest in notes secured by trust deeds.[268] There was little, if any, opportunity to negotiate terms and the Secured Contractual Loan Program was not characteristic of a commercial lending transaction.[269] The impetus to participate was the advertised 10% return on principal.[270] The court concluded that the program constituted a security within the federal securities laws.[271]

The *Reves* Court combined the emphasis on the economic reali-

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260. Id.

261. Id. NMESC borrowed money from lenders. Repayment of the debts was dictated by a corollary contract, the "collateral loan agreement/promissory note." The notes had maturity terms of between one and three years and promised a rate of return of ten percent above principal. NMESC would then use the borrowed funds to buy third party promissory notes secured by deeds of trust. Id.

262. Id.

263. Id.

264. Id.

265. Id.

266. Id.

267. Id at 1430.

268. Id at 1431.

269. Id.

270. Id.

271. Id at 1435.

ties of the instrument in question with an emphasis on the regulatory aspect of the Securities Acts.[272] Recognizing that the 1933-34 Congress intended to encompass within the Securities Acts virtually any instrument which might be sold as an investment, the Court focused upon the incidents which characterized the instrument in the marketplace.[273] The nature of the investment remains the focal point of the analysis.[274] This focus ensures that the spirit of the Securities Acts is fulfilled, while giving deference to the letter of the law.

The Second Circuit established a list of instruments which were commonly known as notes, but were outside the scope of the Securities Acts.[275] To determine the applicability of the Securities Acts, a note in question was compared to the espoused list to determine whether the instrument in question bore a strong resemblance to the list of notes which fall outside the purview of the Securities Acts.[276] This test, the "family resemblance" test, was adopted and further refined by the Supreme Court in *Reves*.[277] There, a questioned note was examined to determine whether the motivation of the buyer and seller which underlay the transaction was of an investment rather than a commercial nature.[278] The plan of distribution was examined to determine whether the instrument was of the type that is characterized by common trading for a speculative purpose.[279] The common perception of the transaction was examined to determine whether it was perceived to be an investment transaction rather than a commercial venture.[280] The final consideration was whether factors were in existence which would render the applicability of the Securities Acts unnecessary.[281] The Securities Acts were drafted in order to require full disclosure of the risks inherent in any speculative transaction.[282] Any instrument which is an investment by nature is subject to the provisions of the Securities Acts,[283] but a commercial transaction is

272. See notes 27 and 28 and accompanying text.
273. See note 30 and accompanying text.
274. See note 42 and accompanying text.
275. *Exchange National Bank*, 544 F2d 1126 (2d Cir 1976).
276. See note 47 and accompanying text.
277. *Reves*, 110 S Ct at 951-52.
278. See notes 48-53 and accompanying text.
279. See notes 54 to 58 and accompanying text.
280. See notes 59 to 64 and accompanying text.
281. See notes 65 to 69 and accompanying text.
282. See note 30 and accompanying text.
283. *Reves*, 110 S Ct at 954.

immune from the scope of the Securities Acts.

Although the Securities Exchange Act and the Securities Act provide an exemption for notes with a maturity not in excess of nine months, this exemption is a qualified exclusion.[284] The definition section of the Securities Exchange Act states that the definitions are general in nature. If the context otherwise requires, the strict letter of the law is capable of flexibility. The spirit of the Acts mandates that these notes be considered as within the Securities Acts due to their investment nature.[285]

The motivations behind the transaction characterize the exchange as an investment transaction.[286] The notes were sold in a common offering.[287] Due to the advertising scheme and the advertised rate of return, the public justifiably perceived the instruments as a security venture.[288] If the Acts were held not to apply to the notes in question, they would not be subject to any federal regulation.[289] These factors require that the vehicle be governed by the Securities Acts, in spite of the exemption under section 3(a)(10).

Justice Stevens' concurrence found additional support for the holding in the prior construction which was given to the exemption.[290] The construction which had been given to the exemption by the courts and the SEC was as solely an exclusion for commercial paper.[291] The legislative history also spoke of the exemption as exclusive to commercial paper.[292] This narrow construction is not in accord with the spirit or the letter of the law.[293]

The Acts were drafted in broad terms in order to afford the courts latitude to effectuate the purpose underlying the Securities reform. The use of credit for speculative purposes is the quintessential securities exchange.[294] To allow categorization of an instrument based on a single facet of the instrument serves to vitiate the purpose of the law.[295] This concept is reinforced by the strict letter

284. See note 27 and accompanying text.
285. See Ianni, 100 Bank L J 100, 103 (cited in note 30).
286. See notes 48 to 53 and accompanying text.
287. See notes 54 to 58 and accompanying text.
288. See notes 59 to 64 and accompanying text.
289. See notes 65 to 69 and accompanying text.
290. See note 87 and accompanying text.
291. Securities and Exchange Commsn, Release No 33-4412, 26 Fed Reg 9158 (1961).
292. *Reves*, 110 S Ct 957.
293. See note 123 and accompanying text.
294. See Ianni, 100 Bank L J 100, 103 (cited in note 30).
295. See note 37 and accompanying text.

of section 3(a)(10).[296] The spirit of the law comports with the literal wording. The definition affords the latitude which the drafters and supporters of the statute intended to create.

To hold that the exemption excludes any note with a maturity not in excess of nine months, as was asserted by Chief Justice Rehnquist, would render the qualifying phrase impotent and stifle the leeway which was built into the statute. The definitions under the Securities Exchange Act specifically state that the definitions are not set in stone.[297] If the context requires otherwise, the courts are free to examine the transaction in light of the definition. The nomenclature is not the determining factor when viewed in light of the Securities Acts.[298]

To hold that the demand nature, in and of itself, removes the instrument from the ambit of the Securities Acts would also be violative of the spirit and letter of the law.[299] The demand nature does not serve to mitigate or eviscerate the risk which is inherent in the Co-op's venture. The demand nature does not overcome the investment nature of the transaction, the presence of a common offering, or the public perception that the instrument constitutes a security.

The current trend, as evidenced by *Reves*, has given effect to the words of the statute while remaining true to the purpose of the legislation. With the retirement of Justice Brennan however, the direction which the Court will follow in the future is uncertain. The remaining members of the Court are evenly split on the issue of the interpretation of the Securities Exchange Act. Justice Souter is likely to be a driving force in the development of the definition of a security and the exclusion under the 1934 Securities Exchange Act, because he will likely act as the deciding vote in the next securities issue.

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296. See note 27 and accompanying text.
297. See section 3(a)(10) at note 27.
298. See note 37 and accompanying text.
299. See Ianni, 100 Bank L J 100, 103 (cited in note 30).